California Credit Union League
Serving Credit Unions in California and Nevada

April 20, 2006

Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Comments on Part 715 ANPR, Supervisory Committee Audits

Dear Ms. Rupp:

On behalf of the California and Nevada Credit Union Leagues, I appreciate the opportunity to comment on the National Credit Union Administration's (NCUA) advance notice of proposed rulemaking (ANPR) regarding whether and how to modify the agency's Supervisory Committee audit rules in four main areas to:

- Require credit unions to obtain an "attestation on internal controls" in connection with their annual audits;
- Identify and impose assessment and attestation standards for such engagements;
- Impose minimum qualifications for Supervisory Committee members; and
- Identify and impose a standard for the independence required of state-licensed, compensated auditors.

The California and Nevada Credit Union Leagues (Leagues) are the largest state trade association for credit unions in the United States, serving the interests of more than 450 member credit unions and their 9 million members. California and Nevada are also home to over one-fifth of the 207 U.S. credit unions within the primary scope of this ANPR (i.e., assets greater than $500 million).

Our Position on Internal Control Assessment and Attestation

The Leagues staunchly oppose requiring an attestation on internal controls for credit unions of any asset size. We believe it is a harmful and expensive solution to a nonexistent problem. As NCUA is well aware, the Sarbanes-Oxley Act of 2002 was passed and implemented as a direct result of a series of financial scandals involving publicly-held companies. It is plainly clear from a review of the Act and its history that Congress did not intend the Act to apply to non-public companies, including credit unions. Indeed, the primary factors present in the public marketplace that were the impetus in passing Sarbanes-Oxley are virtually nonexistent in the credit union environment.

Unlike publicly-held companies, credit unions do not have the pressures to meet shareholder or market expectations of income or stock price. In addition, credit union CEOs, CFOs, or other insiders cannot become personally enriched by fraudulent manipulation of financial statements or financial performance in the fashion of Enron, et al. The inherent structure of credit unions—non-profit, mutually-owned, and democratically controlled—essentially eliminates insider temptation to engage in fraudulent financial reporting.

Further, in passing Sarbanes-Oxley, Congress was attempting to provide reassurance to investors that their interests in public companies were protected against potential internal fraud. By contrast, the funds of credit union owners/members are already protected by the NCUSIF and, at some credit unions, by private share insurance. To our knowledge there have been no recent credit union failures or scandals of a magnitude sufficient to weaken that insurance system, nor has NCUA provided any statistical or anecdotal information in the ANPR to indicate this. In fact, a review of credit union failures and insurance fund losses by the Federal Reserve Bank of San Francisco found that credit unions tended to have lower loss rates on their insurance fund than did commercial banks.[1]

We believe members do not need assurances from credit unions in the form of attestations on their internal controls in order to feel safe about their funds. They already have a strong insurance fund that provides them more security and peace of mind than the requirements imposed on public companies by Sarbanes-Oxley. This was evidenced in part by an October 2005 *Wall Street Journal* poll which indicated that investors are still not very confident Sarbanes-Oxley is serving to rein in inappropriate behavior by corporate executives.[2] By comparison, we are unaware of (and the ANPR does not cite any) similar concerns being voiced by credit union members about current credit union internal control practices.

We also fail to see how an attestation on internal controls would serve to provide a greater degree of risk-mitigation to the insurance fund than current credit union regulations and practices governing corporate governance and auditing (e.g., NCUA Rules and Regulations Part 715). Credit unions are already required to have their Supervisory Committees, internal auditors, or external auditors verify the sufficiency of their internal controls and the accuracy of their financial reports. Simply adding an attestation requirement will do nothing to enhance these existing requirements and processes, while adding significantly to credit unions' audit costs.

The high cost of complying with the requirement for an attestation on internal controls for public companies (contained in Section 404 of Sarbanes-Oxley) has been widely reported in the financial press. These costs are not just initial, first-year costs but are ongoing. A recent survey of year two Section 404 costs done by Financial Executives International (FEI)

[1] Wilcox, James. August 19, 2005. "Credit Union Failures and Insurance Fund Losses: 1971-2004." *FRBSF Economic Letter* Number 2005-20.
[2] The Wall Street Journal Online. October 20, 2005. Volume 1, Issue 5.

found that auditor attestation fees alone still constituted 45 percent of a company's total audit fees, meaning that they were almost as much as the fees paid for just the annual financial statement audit.[3] This does not include the additional external consulting and internal costs usually required to assist management with developing, documenting, and assessing the effectiveness of a credit union's internal controls.

The FEI study also indicates that, for smaller companies, total Sarbanes-Oxley costs (including auditor attestation fees) represent a significantly larger proportion of revenue than costs for larger companies. Since most large credit unions would likely be considered "small" in the publicly-held company sector (respondents in the survey reported annual sales revenue from less than $25 million to more than $25 billion), virtually all credit unions subjected to an attestation requirement would experience a disproportionate financial burden. In addition, the FEI study showed that small companies actually experienced an increase in attestation fees (4.7 percent) and internal staff hours (6.3 percent) from year one to year two of Section 404 compliance. Imposing costs of this magnitude on credit unions will serve only to impair their competitiveness and ability to serve their members.

We would also like to point out that recent developments at the SEC may lead to many companies being exempted from Section 404 of Sarbanes-Oxley. Earlier this year, the SEC's Advisory Committee on Smaller Public Companies proposed that smaller public companies (those with a market capitalization of less than $787 million; accounting for 80 percent of all U.S. public companies) should be exempt from all or part of Section 404. The comment period for the committee's proposal ended April 3 and is expected to be considered by the SEC on May 10. While there is uncertainty as to whether, or what parts of, the committee's proposal will be adopted by the SEC, it is of no small significance that the public sector is debating the wisdom of continuing to require an attestation on internal controls for four-fifths of its population.

The bottom line: Requiring an attestation would provide no advantage to credit unions, nor would it provide any advantage or reduced risk to the NCUSIF. It would, however, serve to greatly increase the regulatory and financial burden for many credit unions. It is apparent that credit union costs to comply with an attestation requirement would far outweigh any potential benefits. This has already been demonstrated in the public sector; the year two FEI survey cited earlier also found that 85 percent of respondents still believe that the costs of complying with Section 404 of Sarbanes-Oxley exceed the benefits.

Our Position Regarding Internal Control Assessments and Attestations Standards

While we oppose requiring an attestation on internal controls for credit unions of any asset size, we believe that it is reasonable to consider a standard for all credit unions to use when evaluating, maintaining, and assessing the effectiveness of its internal controls. However,

[3] Financial Executives International. "FEI Survey on Sarbanes-Oxley Section 404 Implementation." March 2006.

we think it would be more appropriate to evaluate and comment on this issue through a separate rulemaking process.

Our Position on Minimum Qualifications for Supervisory Committee Members

While it would be ideal if all Supervisory Committee members had a minimum level of experience and expertise in the financial services industry, it is simply not realistic to expect it (much less require it). Many credit unions already have difficultly attracting and retaining individuals for the non-compensated position of Committee member. Imposing minimum qualifications would serve to make this even more difficult.

More importantly, we believe that NCUA does not have the authority to impose qualifications for Supervisory Committee members beyond the limited qualifications already contained in §1761 of the FCU Act (i.e., a member, not on the board). It is outside the purview of NCUA to add its own additional qualifications to those Congress has already established.[4] However, we do think it is reasonable to have Supervisory Committee members (regardless of credit union asset size) undergo basic, credit union-developed training on the duties and responsibilities of Committee members as laid out in the Supervisory Committee Guide.

We do not believe that Supervisory Committee members need access to their "own" counsel, but they should be permitted access to legal counsel, if necessary. Access to legal counsel should not be predicated on any minimum credit union asset size.

While we acknowledge the importance of ensuring that Supervisory Committee members must be independent and free of conflicts of interest, we oppose setting a minimum credit union asset size to address the issue. An effectively crafted corporate code of ethics would be able to address the large customer situation discussed in ANPR question #12.

Our Position Regarding Independence of State-Licensed, Compensated Auditors

An auditor should only be required to meet the AICPA's independence standards. The SEC's independence standards were designed for the public company sector and, for the same reasons that Sarbanes-Oxley requirements should not be imposed on credit unions, are inappropriate for the credit union environment.

Our Position Regarding Audit Options, Reports, and Engagements

Lastly, NCUA requested comments regarding several miscellaneous issues within the scope of Part 715. We would like to comment on two of those issues: 1) the value in retaining the "balance sheet audit" for credit unions under $500 million in assets (Question 15); and 2)

[4] See NCUA Legal Opinion Letter 94-1011 for a related discussion re: a credit union attempting to impose qualifications for board members beyond what the FCU Act permits.

the value in retaining the "Supervisory Committee Guide audit" for credit unions under $500 million in assets (Question 16).

We believe there is value in retaining the balance sheet audit. While call report data indicates that over 80 percent of credit unions elect to obtain either a financial statement audit or a Supervisory Committee audit performed by state-licensed persons or other external auditors, we believe credit unions should be permitted to balance costs and benefits when deciding on which audit to obtain. We believe the balance sheet audit option permits credit unions that flexibility, and should be retained.

We also believe there is value in retaining the Supervisory Committee Guide audit. As noted above, this audit (performed by a state-licensed person or other external auditor) is utilized by many credit unions. We realize that concerns can be raised when this audit is instead performed by the Supervisory Committee or designated staff, but we believe these concerns can be addressed with proper training of those conducting the audit (see our response to Supervisory Committee minimum qualifications above). The Supervisory Committee Guide audit option is a cost-effective value for small credit unions, and should be retained.

In closing, the California and Nevada Credit Union Leagues thank the NCUA for the opportunity to comment on this Advanced Notice of Proposed Rulemaking. We understand this is merely an initial request for comments and not a proposed rule. Our comments on these issues are being submitted with the hope and urging that NCUA will reconsider its approach.

Sincerely,

Bill Cheney
President/CEO
California and Nevada Credit Union Leagues